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No. 518

In the Supreme Court of the United States

OCTOBER TERM, 1942

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SABINE TRANSPORTATION COMPANY, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE PETITIONER

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OPINIONS BELOW

The memorandum opinion of the Board of Tax Appeals (R. 19–22) is unreported. The opinion of the Circuit Court of Appeals (R. 33–36) is reported at 128 F. 2d 945.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered June 30, 1942. (R. 36.) A petition for rehearing was filed on July 18, 1942, and denied August 13, 1942. (R. 37.) A petition for a writ of certiorari was filed on November 9, 1942.

and granted on December 14, 1942. The jurisdiction of this Court is conferred by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

In 1937 taxpayer declared and paid a dividend in its own notes for the face amount of which it claimed and was allowed a credit in the computation of its undistributed profits tax for that year. Did Section 27 (a) (4) and (e) of the Revenue Act of 1938 entitle the taxpayer to a second dividends paid credit upon redemption of the identical notes in 1938?

STATUTES AND REGULATIONS INVOLVED

The statute and regulations involved will be found in the Appendix, *infra*, pp. 15–21.

STATEMENT

The facts as stipulated (R. 10–19) were adopted by the Board of Tax Appeals as its findings (R. 19). They may be summarized as follows:

Taxpayer is a Delaware corporation with its principal office in Texas. It has only two stockholders. In 1937 it paid dividends of $30,000 in cash and $530,000 in its own ten-year eight per cent notes. For undistributed profits tax purposes, in its return for 1937 taxpayer claimed a dividends paid credit of $641,562.60, consisting of the cash and also of the full face amount of the notes

paid out as dividends, plus a dividend carry-over from the previous year. The Commissioner allowed this credit, but made adjustments in other items reported in the return, not here material, with a resulting deficiency in normal tax of $2,256.43 and in undistributed profits surtax of $117.40, to which taxpayer agreed. (R. 19–21.)

In 1938 taxpayer paid its two stockholders the full face amount of the foregoing dividend notes, and retired them. In its return for 1938 taxpayer claimed a second credit of the full face amount of these notes, this time under Section 27 (a) (4) of the Revenue Act of 1938, dealing with amounts used to retire indebtedness incurred before the beginning of that year. The Commissioner disallowed the credit for 1938 because of Section 27 (e) of the 1938 Act and Article 27 (a)–3 of Treasury Regulations 101. He was sustained by the Board. (R. 21–22.) The taxpayer appealed, and the Circuit Court of Appeals reversed. (R. 36.)

SPECIFICATION OF ERRORS

The Circuit Court of Appeals erred:

(1) In allowing the taxpayer a second credit upon the redemption of notes in 1938, which in 1937 when they were issued had been the occasion of a dividends paid credit equal to their full face amount.

(2) In reversing the decision of the Board of Tax Appeals.

SUMMARY OF ARGUMENT

Both the Revenue Act of 1936 and the Revenue Act of 1938 provide for a surtax upon undistributed corporate profits. In the computation of undistributed corporate income subject to surtax, each statute allows a credit for dividends paid, and special credits in certain circumstances where dividends are difficult or impossible. Each statute contains a provision for the credit allowable when dividends are paid in the corporation's own bonds or notes. Revenue Act of 1936, Section 27 (d); Revenue Act of 1938, Section 27 (e). The total amount of the credit allowable is equal to the total amount of the dividend paid; but a portion of the credit, equal to the market or face value of the notes, whichever is less, is allowed in the year of the issuance of the notes. The portion allowable in the year of the redemption of the notes is limited to the excess of the redemption price over the fair market value of the notes when issued, and is permitted only if that fair market value was less than face value. In the instant case, the fair market value of the dividend notes when issued was equal to their face value; and the taxpayer received a credit for the full face amount of the notes in the year of issuance. Accordingly, it is not entitled to any credit in the year of redemption.

Section 27 (a) (4) may not be invoked to obtain the credit because it is a general provision

dealing with the redemption of indebtedness of all kinds, and is here controlled by the special provision, Section 27 (e), which deals with the redemption of *dividend obligations*. The Treasury regulation which so provides is a valid administrative interpretation supported by several accepted canons of statutory construction, *viz.*: The rule that a special statutory provision controls an inconsistent general one; the rule that a harmonious statutory scheme should be sought and absurd results avoided; the rule that double deductions should not be allowed; and the rule that credit provisions of this type must be strictly construed.

ARGUMENT

SECTION 27 OF THE REVENUE ACT OF 1938 DOES NOT AUTHORIZE A CREDIT FOR THE RETIREMENT OF NOTES, WHICH WOULD DUPLICATE A CREDIT PREVIOUSLY ALLOWED UPON THE ISSUANCE OF THE NOTES IN PAYMENT OF A DIVIDEND

In 1937 taxpayer paid a dividend in its own promissory notes. In its income tax return for that year it claimed a dividends paid credit for the full face amount of the dividend notes issued. The Commissioner allowed the credit, which was fully used in reduction of the tax. These notes were redeemed in 1938. The taxpayer claimed a second dividends paid credit in its 1938 return. This the Commissioner disallowed. The Board sustained him, relying upon its own decision in

Spokane Dry Goods Co. v. *Commissioner*, 43 B. T. A. 793,[1] which was subsequently affirmed by the Circuit Court of Appeals for the Ninth Circuit, 125 F. (2d) 685.[2] The decisions of the Board and the Circuit Court of Appeals for the Ninth Circuit are in agreement with the terms of Article 27 (a)–3 of Treasury Regulations 101 (Appendix, *infra* p. 19), which is submitted to be a valid administrative interpretation of the pertinent Section 27 (a) (4) and (e) of the Revenue Act of 1938 (Appendix, *infra* pp. 16, 17). However, the Circuit Court of Appeals for the Fifth Circuit reversed the Board of Tax Appeals in the instant case and invalidated the Treasury regulation. We submit that the decisions of the Board and Circuit Court of Appeals for the Ninth Circuit are correct, and that the decision of the court below in the instant case is wrong.

1. Both the Revenue Act of 1936 and the Revenue Act of 1938 imposed a tax on undistributed corporate profits. Under the Revenue Act of 1938 this was accomplished by the computation of a tentative tax of 19 per cent of adjusted net income which was then reduced by two and one-half

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[1] This decision was rendered by the full Board with three members dissenting.

[2] The following decisions are also in the Commissioner's favor: *Journal Co.* v. *Commissioner*, 46 B. T. A. 841; *Jos. Schlitz Brewing Co.* v. *Commissioner*, decided April 30, 1942 (Prentice-Hall B. T. A. Service, par. 42,229); *Noble Drilling Co.* v. *Jones* (W. D. Okla.), decided June 27, 1942 (1942 Prentice-Hall, par. 62,879).

per cent of the so-called "dividends paid credit" (but not to exceed two and one-half per cent of adjusted net income). Section 13 (c), Appendix, *infra*, p. 15. The dividends paid credit consisted primarily of the amount of earnings distributed to the stockholders, but included certain special credits in situations where the payment of dividends was difficult or impossible. Section 27. Thus in effect the 1938 statute imposed a tax of 16½ per cent upon adjusted net income, and a surtax of two and one-half per cent upon *undistributed* adjusted net income.

This 1938 surtax was the successor to the undistributed profits surtax imposed by Section 14 of the Revenue Act of 1936 (Appendix, *infra* pp. 17, 18), where the rates were higher and were graduated according to the percentage of adjusted net income remaining undistributed. The 1936 Act also provided for a dividends paid credit and for certain special credits, to be allowed in the computation of undistributed adjusted net income. Sections 26 (c) and 27, Appendix, *infra*, pp. 18, 19.

Each of these Revenue Acts allowed a credit upon the payment of dividends in the corporation's own promissory notes. Revenue Act of 1936, Section 27 (d), Appendix, *infra*, p. 19; Revenue Act of 1938, Section 27 (e), Appendix, *infra* p. 17. Under both statutes, however, the credit allowable at the time of issuance of dividend notes was equal to their fair market value or face value,

whichever was less. And it was further provided that where the notes were subsequently redeemed for more than their market value at the date of issuance, the excess would be allowable as a credit in the year of redemption. Section 27 (e) of the 1938 Act is in this respect carefully dovetailed with Section 27 (d) of the 1936 Act, since it refers to redemptions in taxable years beginning after December 31, 1937, of dividend notes issued in taxable years beginning after December 31, 1935.[3]

In the instant case the taxpayer was allowed a credit for the full face amount of its dividend notes when they were issued in 1937; apparently they were then worth par. In 1938 the notes were redeemed at their face value. Since this had been their market value and the amount for which credit had been allowed at the time of their issuance in 1937, it was implicit in Section 27 (e) of the 1938 Act (as it had been in Section 27 (d) of the 1936 Act) that no redemption credit was allowable in 1938. The theory of both statutes was that the corporation should be entitled to one full credit for the amount of a dividend paid; but if the actual distribution of cash or property was anticipated by the issuance of the corporation's own bonds or notes, that credit might be wholly or partly allowed in the year of issuance of the

[3] The 1936 Act governs computation of income tax for taxable years beginning after December 31, 1935; and the 1938 Act governs taxable years beginning after December 31, 1937. See Section 1 of each Act.

obligations. Only such part as was not allowed in the earlier year was deemed available in the year of redemption.

If there were no other statutory provisions touching the present subject, the Treasury's position would seem to be correct beyond dispute. But the taxpayer claims the 1938 credit not under subsection (e) of Section 27 of the 1938 Act, but under subdivision (a) (4). Section 27 (a) (4) allows a credit for amounts used or irrevocably set aside "to pay or to retire indebtedness of any kind," evidenced by bonds or notes issued before December 31, 1937, "if such amounts are reasonable with respect to the size and terms of such indebtedness." It is the Treasury's position that of these two closely associated and on casual inspection inconsistent provisions,[4] both dealing

[4] Actually they are not inconsistent. Section 27 (a) (4) must be read with the principle in mind that double deductions are not permitted in the absence of clear evidence that Congress intended to allow them (*Ilfeld Co.* v. *Hernandez*, 292 U. S. 62, 68). So read, it does not authorize this double deduction, even standing alone and without taking meaning from Section 27 (e). A limitation against being construed to allow double deductions or credits is implicit throughout Section 27 (a) (4). It allows a creditor deduction for amounts "used or irrevocably set aside" to retire indebtedness; yet certainly it does not permit an amount irrevocably set aside in one year and paid in the next year to be the subject of an undistributed profits tax credit on each occasion. This limitation is not express but is implied from the assumption that Congress did not intend to authorize double credits. The same implication may be drawn in the case at bar for the same reason.

with the redemption of corporate obligations, Section 27 (e) must control here. Section 27 (a) (4) is a general provision relating to indebtness of any kind, but Section 27 (e) is a special provision carving out for particular treatment indebtedness incurred by the payment of dividends in a corporation's own obligations. In accord with the familiar canon of construction, the specific provision must control the general one. *United States* v. *Chase,* 135 U. S. 255, 260; *Rodgers* v. *United States,* 185 U. S. 83, 89; *Baltimore Nat. Bank* v. *Tax Comm'n,* 297 U. S. 209, 215.

Furthermore, to apply Section 27 (a) (4) in cases of this type leads to absurd results. The basic statutory scheme is to impose an additional tax upon corporate earnings which remain with the corporation, but not to tax those earnings if they are distributed and thereby become subject to tax in the hands of the stockholders.[5] To allow one credit for the amount of earnings distributed as a dividend carries out the purpose exactly. But the application of Section 27 (a) (4) to dividend obligations permits the same dividend to give rise to two complete credits in two separate years, and hence frustrates the basic purpose of the statute. When the dupli-

[5] See Message of the President to Congress, March 3, 1936, H. Doc. No. 418, 74th Cong., 2d sess., pp. 2–3; H. Rep. No. 2475, 74th Cong., 2d sess., pp. 3–5 (1939–1 Cum. Bull. (Part 2) 667, 669–670).

cating credit is allowed, the taxpayer is permitted to accumulate an equivalent amount of earnings free of the additional tax.

An even more incongruous consequence logically follows from the application of the taxpayer's theory to facts somewhat different from those in the instant case. If a corporation paid a 1937 dividend in notes worth 75 percent of par, and redeemed the notes at par in 1938, not only would that corporation receive credits aggregating 200 percent of the dividend declared, but, even more astonishing, it would receive a credit of 125 percent of the dividend in the year 1938 alone. Under Section 27 (a) (4) it would receive a credit for the full face amount of the notes retired, and under Section 27 (e) a credit for the excess of the retirement price over the fair market value when issued.

The taxpayer's theory thus violates three accepted canons of construction, in addition to the one already mentioned (that a specific statutory provision controls a general one), namely, the rule that absurd results should be avoided in the interests of a reasonable and logical scheme based upon all of the provisions of the statute read together (*Haggar Co.* v. *Helvering,* 308 U. S. 389, 394; *Armstrong Co.* v. *Nu-Enamel Corp.,* 305 U. S. 315, 332–333; *Helvering* v. *N. Y. Trust Co.,* 292 U. S. 455, 464); the rule that double deductions are to be avoided (*Ilfeld Co.* v. *Hernandez,* 292 U. S. 62, 68; *McLaughlin* v. *Lumber Co.,* 293 U. S. 351, 355;

United States v. *Ludey*, 274 U. S. 295, 301); and the rule that credit provisions of this type are to be construed strictly (*Helvering* v. *Northwest Steel Mills*, 311 U. S. 46, 49; *Helvering* v. *Ohio Leather Co.*, Nos. 40–42, this Term).

The opinion of the court below does not discuss or even cite the crucial statutory provision, Section 27 (e) of the 1938 Act. And although it sets out the first sentence of Section 27 (d) of the 1936 Act in a footnote, it stops short of the second and critical sentence dealing with the credit allowable upon the redemption of dividend notes.* Indeed, a reading of the opinion below would lead one to suppose that there was no statutory provision involved here except Section 27 (a) (4).

2. When Section 27 (e) of the 1938 Act and its predecessor provision are taken into account, it certainly cannot be said, as the court below has done, that the taxpayer's right to the credit under Section 27 (a) (4) is clear. If the contrary is not clear, then at most there is a statutory ambiguity and a proper field for the exercise of admin-

*The court also mistakenly thought that *Pacific Flush-Tank Co.* v. *Commissioner*, 45 B. T. A. 869, was inconsistent with the Board's decision herein. In the *Pacific Flush-Tank* case the Board did not permit double undistributed profits tax credits; the Board merely held that a taxpayer which had secured an ordinary income tax deduction when it issued notes in payment of salaries was entitled to an undistributed profits tax credit later when the notes were redeemed. Furthermore, Section 27(e) was not involved in the *Pacific Flush-Tank* case.

istrative discretion. That discretion was exercised by Article 27 (a) (3) of Treasury Regulations 101, promulgated under the Revenue Act of 1938, wherein it is stated—

> Double credits are not permitted, either for the same year or for separate years. Thus, amounts which have been or may be properly taken as a credit pursuant to section 27 (e) of the Act or section 27 (d) of the Revenue Act of 1936 (both sections relating to dividends in obligations of the corporation) may not again be included in the dividends paid credit under section 27 (a) (4) when the obligations are paid.
> * * *

Certainly this administrative interpretation was not plainly wrong. On the contrary, it gave the only plausible and reasonable construction to the language of the two statutory provisions involved. Consequently it should have been sustained by the Circuit Court of Appeals. *Magruder* v. *Washington, B. & A. Realty Corp.*, 316 U. S. 69; *Fawcus Machine Co.* v. *United States*, 282 U. S. 375; *Brewster* v. *Gage*, 280 U. S. 327, 336; *Maryland Casualty Co.* v. *United States*, 251 U. S. 342, 349; *Spring City Co.* v. *Commissioner*, 292 U. S. 182, 189; *White* v. *Winchester Club*, 315 U. S. 32, 41; *United States* v. *Joliet & Chicago R. Co.*, 315 U. S. 44, 47–48; *Textile Mills Corp.* v. *Commissioner*, 314 U. S. 326, 337–339.

CONCLUSION

The decision of the Circuit Court of Appeals should be reversed.

Respectfully submitted.

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JANUARY 1943.

APPENDIX

Revenue Act of 1938, c. 289, 52 Stat. 447:

SEC. 13. TAX ON CORPORATIONS IN GENERAL.

(a) *Adjusted Net Income.*—For the purposes of this title the term "adjusted net income" means the net income minus the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation the net income of which is more than $25,000 (except a corporation subject to the tax imposed by section 14, section 231 (a), Supplement G, or Supplement Q) a tax computed under subsection (c) of this section or a tax computed under subsection (d) of this section, whichever tax is the lesser.

(c) *General Rule.*—The tax computed under this subsection shall be as follows:

(1) A tentative tax shall first be computed equal to 19 per centum of the adjusted net income.

(2) The tax shall be the tentative tax reduced by the sum of—

(A) 16½ per centum of the credit for dividends received provided in section 26 (b); and

(B) 2½ per centum of the dividends paid credit provided in section 27, but not to exceed 2½ per centum of the adjusted net income.

* * * * *

SEC. 27. CORPORATION DIVIDENDS PAID CREDIT.

(a) *Definition in General.*—As used in this title with respect to any taxable year the term "dividends paid credit" means the sum of:

(1) The basic surtax credit for such year, computed as provided in subsection (b);

* * * * *

(4) Amounts used or irrevocably set aside to pay or to retire indebtedness of any kind, if such amounts are reasonable with respect to the size and terms of such indebtedness. As used in this paragraph the term "indebtedness" means only an indebtedness of the corporation existing at the close of business on December 31, 1937, and evidenced by a bond, note, debenture, certificate of indebtedness, mortgage, or deed of trust, issued by the corporation and in existence at the close of business on December 31, 1937, or by a bill of exchange accepted by the corporation prior to, and in existence at, the close of business on such date. Where the indebtedness is for a principal sum, with interest, no credit shall be allowed under this paragraph for amounts used or set aside to pay such interest.

(b) *Basic Surtax Credit.*—As used in this title the term "basic surtax credit" means the sum of:

(1) The dividends paid during the taxable year, increased by the consent dividends credit provided in section 28, and reduced by the amount of the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations;

* * * * *

(e) *Dividends in Obligations of the Corporation.*—If a dividend is paid in obligations of the corporation, the amount with respect thereto which shall be used in computing the basic surtax credit shall be the face value of the obligations, or their fair market value at the time of the payment, whichever is the lower. If the fair market value of any such dividend paid in any taxable year of the corporation beginning after December 31, 1935, is lower than the face value, then when the obligation is redeemed by the corporation in a taxable year of the corporation beginning after December 31, 1937, the excess of the amount for which redeemed over the fair market value at the time of the dividend payment (to the extent not allowable as a deduction in computing net income for any taxable year) shall be treated as a dividend paid in the taxable year in which the redemption occurs.

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) *Definitions.*—As used in this title—

(1) The term "adjusted net income" means the net income minus the sum of—

* * * * *

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the

specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.

17 per centum of the portion of the undistributed net income which is in excess of 20 per centum and not in excess of 40 per centum of the adjusted net income.

22 per centum of the portion of the undistributed net income which is in excess of 40 per centum and not in excess of 60 per centum of the adjusted net income.

27 per centum of the portion of the undistributed net income which is in excess of 60 per centum of the adjusted net income.

* * * * *

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(c) Contracts Restricting Payment of Dividends.—

* * * * *

(2) *Disposition of Profits of Taxable Year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of

a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

* * * * *

SEC. 27. CORPORATION CREDIT FOR DIVIDENDS PAID.

(a) *Dividends Paid Credit in General.*—For the purposes of this title, the dividends paid credit shall be the amount of dividends paid during the taxable year.

* * * * *

(d) *Dividends in Obligations of the Corporation.*—If a dividend is paid in obligations of the corporation, the amount of the dividends paid credit with respect thereto shall be the face value of the obligations, or their fair market value at the time of the payment, whichever is the lower. If the fair market value is lower than the face value, then when the obligation is redeemed by the corporation, the excess of the amount for which redeemed over the fair market value at the time of the dividend payment (to the extent not allowable as a deduction in computing net income for any taxable year) shall be treated as a dividend paid in the taxable year in which the redemption occurs.

* * * * *

Treasury Regulations 101, promulgated under the Revenue Act of 1938:

ART. 27 (a)–3. *Amounts used or irrevocably set aside to pay or to retire indebtedness.*—(a) *Indebtedness.*—

* * * * * *

Double credits are not permitted, either for the same year or for separate years. Thus, amounts which have been or may be properly taken as a credit pursuant to section 27 (e) of the Act or section 27 (d) of the Revenue Act of 1936 (both sections relating to dividends in obligations of the corporation) may not again be included in the dividends paid credit under section 27 (a) (4) when the obligations are paid. No credit may be allowed under section 27 (a) (4) for amounts used or irrevocably set aside to pay or retire indebtedness which represents an item which is allowable as a deduction from gross income, either for the same year or a different year. Thus the aggregate of the credits allowable under section 27 (a) (4) for amounts used or irrevocably set aside to pay or to retire obligations issued at a discount may not exceed the issue price of such obligations.

* * * * * *

ART. 27 (e)–1. *Dividends in obligations of the corporation.*—Section 27 (e) is concerned solely with the amount of the allowance for dividends paid for purposes of inclusion in the basic surtax credit to the extent that dividends are paid by a corporation in its own obligations. If the corporation ultimately pays a dividend in its own obligations (regardless of the form of the corporate resolution by which the dividend is declared), the amount of the allowance for dividends paid to which it is entitled with respect thereto for the year in which such

dividend is paid is limited to the lesser of the face value or fair market value of such obligations as of the date of payment. If in a taxable year of the corporation beginning after December 31, 1935, the allowance for dividends paid as of the date of payment is limited to the fair market value of the corporate obligations distributed and the corporation redeems such obligations in a taxable year beginning after December 31, 1937, the corporation becomes entitled to an additional allowance for dividends paid in computing the basic surtax credit for the taxable year in which it redeems such obligations, but only in the event that the amount at which such obligations are redeemed is higher than their fair market value at the time of the distribution. The amount of such additional allowance is the excess of the price at which such obligations are redeemed over their fair market value at the time of the distribution, subject to the restriction that such excess be diminished by any amounts which were allowable as deductions for amortized bond discount or bond issue commissions and expenses allocable to the obligations redeemed in computing the net income of the corporation for any taxable year. A corporation is entitled to such additional allowance regardless of the identity of the holders of the obligations at the time of their redemption.

* * * * *

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